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¶1. (SBU) Summary: Managers at the Shenzhen Stock Exchange (SSE) are frustrated that excessive regulation and limited market access for foreign investment banks stymie financial innovation, SSE officials told Embassy Beijing's Financial Attache and Congenoffs. As a large institutional investor, Shenzhen fund management executives also support greater competition in China's brokerage sector, including from foreign investment. Executives at China's only two domestic banks with substantial foreign managerial influence hope the successes they've achieved in financial restructuring will allay concerns of regulators and open opportunities for more foreign investment in the banking sector. They also noted that high reserve requirements have a larger impact in restraining credit growth in small and medium-sized banks with fewer deposits. The appreciation of the renminbi against the U.S. dollar (albeit a modest one in trade-weighted terms) is nevertheless adding to rising cost pressures on exporters and thus beginning to promote a rebalancing of China's economy. End summary.

Shenzhen Stock Exchange Wants More Autonomy

¶2. (SBU) SSE Officials expressed frustration that excessive regulation stymies financial innovation. Vice Director for Strategy and International Relations Jane Wu complained that all new listings must be approved by the Chinese Securities Regulatory Commission (CSRC), which has frozen initial public offerings (IPOs) for companies that meet the SSE's listing requirements. In addition, Wu lamented the long delay in the CSRC's approval of trading in stock index futures on the Shanghai Financial Futures Exchange. Approval would increase market liquidity by allowing investors to take both short and long positions. Similarly, the Shenzhen Stock Exchange has been waiting more than six months for approval of a new board that would focus on start-up and other young companies. New product development also suffers from the lack of access for international investment banks, according to Wu.

Investors Need Financial Product Diversification

¶3. (SBU) Top management at Shenzhen's Bosera Asset Management Company also wants to see greater opening of China's financial products market. While the firm has grown significantly, with 13 different fund products, with over USD 18 billion under management, company president Xiao Feng said foreign assets were still too small a share of Chinese investors' portfolios, preventing effective

diversification. Xiao supports further expansion of the Qualified Domestic Institutional Investor (QDII) program, which allows domestic investors to invest overseas, and the Qualified Foreign Institutional Investors (QFII) program, which allows foreign investors to invest in China, stating that both programs benefit his firm and other local fund managers. As a large institutional investor, Xiao noted the benefits of increased foreign investment in the securities sector as it uses Gaohua Securities as its broker (Note: Goldman Sachs effectively controls Gaohua) and would welcome more foreign firms providing research and brokerage services.

¶4. (SBU) Investor education is a major priority at Bosera, especially as the firm's customer base has ballooned from 1 million investors to 10 million in 2007 alone. Bosera officials admitted that many of these customers are new to stocks and may not understand the risks. In addition to establishing a customer information hotline and distributing a pamphlet of frequently asked questions to customers, the company published a best-selling investment book and hosted 200 investor information sessions at hotels and other venues throughout China.

¶5. (SBU) Nevertheless, the meeting with Xiao raised doubts about how customers would react to a sudden downturn in the market and whether Chinese mutual fund companies have adequate contingency plans to handle large-scale redemptions. Xiao pointed out that Bosera's website had been able to handle up to 70,000 inquiries at a time (Comment: Inquiries could be in the millions during periods of market stress. End comment). When asked how Bosera would respond to a surge in redemptions, Xiao said the firm had the authority to delay filling redemption orders of more than 10 per cent of a shareholder's investment. He expressed confidence that most clients are aware of this policy, but admitted that few customers actually have read the details in the prospectus. (Comment: Xiao notably did not mention efforts to establish bank lines of credit to meet

redemptions. End comment).

Foreign Control Does Not Break the Bank

¶6. (SBU) Executives at Shenzhen Development Bank (SDB) and Guangdong Development Bank (GDB) described dramatic turnarounds at both banks within one year of assuming control over day-to-day operations. Shenzhen Development Bank has run a substantial profit for over half of the 28-month period since American investors took over in 2005. Guangdong Development Bank will soon announce profits exceeding internal targets by more than 100 per cent for the second half of 2007 -- only 16 months after taking control. In both cases, officials stressed that the large spread between deposit and lending rates (resulting from a ceiling on the former and floor on the latter) makes Chinese banking highly profitable with even modest efforts to rationalize costs and improve the quality of lending. These include holding branch managers accountable for collection of non-performing loans (NPLs) and improving customer service through increased bank tellers and ATMs. GDB's Zink noted the long-term importance of cutting costs and developing non-interest sources of revenue as interest rate controls would eventually be phased out and NPLs will follow a cyclical downturn.

¶7. (SBU) Executives at both banks are cautiously optimistic that the results of a survey conducted by the Chinese Banking Regulatory Commission (CBRC) on market conditions for foreign banks in the country will lead to further opening. Survey results are expected in the spring and will likely form the basis of CBRC recommendations to the State Council on future banking reform. As the only two domestic joint-venture banks in China with substantial foreign managerial control, SDB and GDB hope their success will help allay concerns among regulators and open opportunities for more foreign investors to take control of Chinese banks.

Non-Performing Loans Falling Rapidly

¶8. (SBU) Non-performing loans at Shenzhen Development Bank peaked at 11.3 per cent in mid 2005, not long after Newbridge Capital

purchased its controlling stake in the struggling bank. Chief Credit Officer Li Wenhuo said the NPL ratio dropped by almost half in two and a half years (ref A) as lending expanded under more sound risk management policies. However, the decline in the ratio was due mainly to an expansion in loans. The absolute value of NPLs did not substantially decline until the second half of 2007 when the bank's collection efforts began to yield positive results. SDB formed teams with legal, prosecution, and police experience to press borrowers in arrears to turn over assets. Li hopes that continued collections on legacy loans combined with SDB's continued track record of only 0.2 percent of new loans becoming non-performing will lead to a double decline in both ratio and absolute total of NPLs in
¶2008.

¶9. (SBU) Michael Zink, President of Guangdong Development Bank, described a similar decline in NPLs by holding branch managers and loan officers accountable for the collection of bad loans. Only one case required a court judgment to assist in resolution. Zink said Communist Party officials within the bank occasionally warned of potentially sensitive loans. In those cases, management allowed Party officials to lead collection efforts.

¶10. (SBU) Both SDB and GDB officials explained how monetary authorities' efforts to limit credit expansion through sterilization, increased reserve requirements, and asymmetric increases in administered interest rates (with deposit rates rising more than lending rates) had impacted their income. SDB officials noted that the PBOC's most recent rate hike, which raised deposit rates more than lending rates (to limit the transfer of assets to equity markets) but lowered the interest rates on demand deposits, would in fact increase the bank's net interest income, given that 40 percent of SDB's deposits were demand deposits. Officials of both banks told how the increase in reserve requirements constrained their lending more than the big state-banks given that their retail deposits, and thus excess reserve holdings with the central bank, are smaller. Neither SDB nor GDB officials were excessively concerned about efforts to limit credit growth through enhanced and quarterly enforcement of tighter lending quotas as both institutions intended to increase income by improving the profitability of their loan portfolio, not just by loan growth. SDB had sold off some NPLs and GDB is reducing its participation in lending syndicates to large credit-worthy SOEs to make rooms for more profitable lending (such as commercial real estate) under existing quotas.

¶11. (SBU) According to Zink, relations among shareholders and

stakeholders remain the biggest managerial challenge at GDB (ref B). Both China Life and Citibank hold an equal share of equity (20 percent) and, given GDB's profitable outlook, both want to assume control. Moreover, the Communist Party continues to play a major role in the appointments of senior management, which makes it difficult to hold senior management accountable to meeting financial targets. This differed significantly from the Party's much less operational role in Citibank (China).

RMB Appreciation helping to shift China economy
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¶12. (SBU) Executives at Nike and Guoguang Electric (audio speakers) highlighted the challenges caused by the recent appreciation of the renminbi against the U.S. dollar (USD) for China-based manufacturers. Nike does not bear currency risk because all of its purchasing contracts with factories in China are USD-denominated. Instead, Nike works closely with its contracted factories to help them find ways to cope with currency appreciation, mainly by cutting costs. While the recent tight market for skilled workers may ease in the short term given the closure of several neighboring low-end assembly operations, worker retention continues to be the area of highest cost for Nike's contract factories. While Nike continues procurement from Chinese firms in apparel and footwear, it has shifted orders for equipment towards Vietnamese suppliers. At the same time, Nike China is looking to expand its sales to China's domestic market.

¶13. (SBU) Guoguang produces audio speaker components. Less than

five percent of its product is sold in China, and currency-related losses were 10 per cent of total revenue in 2007. Guoguang's export prices are all USD-denominated in inflexible one-year agreements. Given the cost of long term foreign currency hedging in China, Guoguang tries to roll out new products at a faster rate to replace old export contracts with new ones at current exchange rates. Mr. Zheng Yamin estimated that his company will become unprofitable at RMB/USD 6.5, at which point Guoguang will have to either move operations to a cheaper location (they have begun to look in China's west) or invest heavily to increase labor productivity. The reduction of the value-added tax (VAT) refund also raised costs, and Zheng complained about the lack of advance warning on reductions in VAT rebates. He pointed out that Guoguang primarily competes against other manufactures in Taiwan and Korea, so RMB appreciation tilts the advantage to his overseas competitors. (Comment: Though to date most other Asian currencies have appreciated more against the USD than the RMB. End comment).

¶14. (SBU) In response to higher wages, taxes and a more appreciated exchange rate Nike, Guoguang, and South China AmCham have all observed a shift of manufacturing toward China's center and west. Guangzhou AmCham cited estimates of some 5-6000 factory closings in the Pearl River Delta (PRD).

¶15. (SBU) Comment: The discussions with SSE and Bosera highlighted the importance of stressing to Chinese officials and the Chinese public how barriers to foreign investment erected by regulators to protect some Chinese firms (i.e. underwriters and brokerages) can harm other constituents of the same regulators. The Communist Party's continued influential role in Chinese financial institutions, and the tension it creates with foreign investors trying to import commercially-oriented managerial practices, may account for some of the political opposition to foreign acquisitions of large Chinese companies. End comment.

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